

IMPACT OF THE FEDERAL TAX RELIEF ACT OF 2001 ON VIRGINIA'S ESTATE TAX

On June 7, 2001, President Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001 ("Tax Relief Act") which generally will become effective on January 1, 2002. This memorandum discusses the impact of the Act on the Commonwealth's estate tax.

Federal law (prior to January 1, 2002)

Federal estate tax laws provide taxpayers with a credit against federal estate taxes owed ("federal credit") in the amount of state estate taxes paid, not to exceed certain maximum amounts. These maximum amounts are calculated according to a formula that increases the amounts according to the size of the taxable estate. In no event, however, can the amount of this credit exceed the amount of federal estate taxes owed.

In this regard, one of the major determinants in the amount of federal estate taxes owed is the "unified credit," a single credit applicable to both estate and gift taxes. (For purposes of this article, the gift tax aspects will not be discussed). Currently, this credit effectively exempts the first \$675,000 of the taxable estate. In other words, no federal estate tax is owed on taxable estates worth \$675,000 or less. The amount of this unified credit (prior to the new federal law discussed below) was scheduled to gradually increase to \$1 million by 2006.

Virginia (current law)

Virginia's estate tax operates to impose a tax in an amount that equals the maximum amount of the "federal credit." This state tax, referred to as a "pick-up" tax, has never increased the total taxes paid by estates, because the pick-up tax reduces, dollar for dollar, the amount of federal estate taxes due. In other words, if Virginia did not collect the tax, the federal government would.

Not surprisingly, all states, as well as the District of Columbia, impose a pick-up tax. Virginia, 37 other states, and the District of Columbia impose the pick-up tax as the **only** state death tax. The other 12 states impose the pick-up tax in addition to a separate state estate tax or inheritance tax.

Virginia's estate tax law, however, differs from almost all of the other states' laws in one major respect. Section 58.1-901 of the Code of Virginia states that the amount of the federal credit shall not "be less than the federal credit allowable by § 2011 of the Internal Revenue Code **as it existed on January 1, 1978.**" (Emphasis added). The other states

(except for New York and Washington) accept the amount of the federal credit as it exists in federal law at the time of the decedent's death. (The importance of this difference is discussed in the section of this article titled "Impact on Virginia").

In the fiscal year ending June 30, 2000, the Commonwealth collected \$150.1 million of estate taxes.

New Federal Law

The new federal "Tax Relief Act" alters federal estate tax law in three major respects.

1. It reduces the amount of the "federal credit" (i.e. pick-up tax) beginning January 1, 2002, by 25% each year until it no longer exists on and after January 1, 2005. Beginning January 1, 2005, the credit is replaced by a deduction that reduces the value of the estate subject to the federal estate tax in an amount equal to all state death taxes actually paid.
2. It increases the exclusion amount used to compute the unified credit to \$1 million in 2002 and gradually increases the credit applicable to estate taxes to \$3.5 million by 2009.
3. It completely repeals federal estate taxes in 2010.

The federal Act provides that all of these changes will sunset in 2011 unless reenacted by Congress.

Impact on Virginia

The three major changes to federal estate tax laws will affect Virginia estate taxes as follows.

- Reduction of federal credit -- Under **current** Virginia law, the gradual reduction of the federal credit beginning January 1, 2002, and its elimination on January 1, 2005, will **not** affect Virginia's estate tax revenues. As mentioned, § 58.1-901 of the Code of Virginia ties Virginia's definition of the amount of the "federal credit" for purposes of determining the amount of Virginia estate taxes, to the maximum amount of such credit as provided under the federal law as it existed on January 1, 1978. Accordingly, contrary to the results in most other states, reductions to the credit under the new federal law will **not** reduce the credit as currently defined by Virginia, and thus will not reduce the amount of tax imposed by the Commonwealth.

Under such circumstances, however, the Commonwealth's estate tax no longer would be a pure "pick-up" tax. That is, to the extent the amount of Virginia's estate tax exceeds the new reduced federal credit, it will constitute an amount that otherwise would not have been paid to the federal government. This situation has not occurred previously because the federal credit formula has remained the same since 1978. Thus, if the General Assembly wishes to phase out Virginia's estate tax on the same schedule as that for the federal credit, then legislative action is required.

- Increase in unified credit -- The gradual increase in the credit to \$3.5 million by 2009 will reduce Virginia's estate tax revenues more than they would have been reduced under the current schedule that would gradually have increased the credit to \$1 million by 2006. The Virginia Department of Taxation is in the process of calculating an estimate of the amount of this reduction.
- Repeal of the federal estate tax -- The triggering event for the imposition of the Virginia estate tax is the "transfer of the taxable estate." Section 58.1-901 of the Code of Virginia states that " 'taxable estate' means 'taxable estate' as defined in § 2051 of the United States Internal Revenue Code of 1954, as amended or renumbered, or the successor provision of the laws of the United States." Unlike the Virginia definition of "federal credit", which has a "fixed" conformity date with federal law of 1978, the Virginia definition of "taxable estate" changes as the federal law changes ("rolling conformity"). Accordingly, when the federal estate tax is repealed in 2010 there will no longer be any "taxable estate." As a result, under current Virginia law, in 2010 there will be no "transfer of the taxable estate," and therefore no imposition and collection of the Virginia estate tax.

Of course, all of these results will be negated beginning in 2011 unless Congress repeals or extends the 2011 sunset date.